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Twenty-First Century Insurance and Loss Distribution in Tort Law

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Abstract

TWENTY-FIRST CENTURY INSURANCE AND LOSS DISTRIBUTION IN TORT LAW Kenneth Abraham University of Virginia School of Law This paper locates tort liability within our larger system of compensation for injury and illness, and compares the tort system's functioning and scope with the other methods of loss distribution that are employed by the system. This review reveals the extent to which there is in fact a vast system of loss distribution, of which tort is only a small part. On the other hand, that system is by no means comprehensive; it contains important gaps. The central issue is whether these gaps should be filled by tort or by the other sources, and how that might be accomplished. The paper then turns to the relationship between tort and the rest of the loss distribution system. It analyzes the different possible relationships by identifying and exploring the loss distributional and other impacts of four possible variants of the collateral source rule. My conclusion is that none of these variants satisfactorily reconciles the tension between tort law's deterrence goal and its comparative ineffectiveness at loss distribution. Finally, the paper looks at the rarely-considered, distinct treatment accorded to life insurance and savings under existing rules, and then recommends a "full-subrogation" approach to tort law's treatment of collateral sources. In order to retain tort law's deterrence potential but enhance overall loss distribution, potential tort victims should be permitted to transfer their full causes of action to their first-party insurers, in return for broader coverage or lower premiums.

TWENTY-FIRST CENTURY INSURANCE AND LOSS DISTRIBUTION IN TORT LAW

Kenneth S. Abraham*

As recently as the middle of the 20th century, loss distribution was at the center of debate about the proper functions of tort law. Tort theorists such as Fleming James, Roger Traynor, and Charles Gregory argued that greater liability should be imposed on enterprises whose activities cause physical injury and damage[1]. One of the principal bases for this argument was that business and professional enterprises were in the best position to spread the cost of losses associated with their activities, either directly, by increasing the price of their products and services, or indirectly, by purchasing liability insurance.[2]

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[1]James's campaign for the adoption of enterprise liability is reflected both in his torts treatise and in a series of articles he authored both before and after publication of the treatise. *See generally* FOWLER W. HARPER AND FLEMING JAMES, JR., THE LAW OF TORTS (1956). Traynor's most famous statement of his position favoring enterprise liability was his concurring opinon in Escola v. Coca Cola Bottling Co. of Fresno, 150 P.2d 436 (1944). Gregory's position is expressed in Charles W. Gregory, *Trespass, to Negligence, to Absolute Liability*, 37 VA. L. REV. 359 (1951). For an account of the overall movement, see George L. Priest, *The Invention of Enterprise Liability*: *A Critical History of the Intellectual Foundations of Modern Tort Law*, 14 J. LEGAL STUD. 461 (1985). A fairly recent effort to revive the movement can be found in VIRGINIA E. NOLAN & EDMUND URSIN, UNDERSTANDING ENTERPRISE LIABILITY (1995).

[2]Dean Prosser, the leading tort scholar of the time, also acknowledged loss distribution as a legitimate function of tort law. *See* WILLIAM L. PROSSER , HANDBOOK OF THE LAW OF TORTS 22 (4th ed. 1971). The classic exposition of the relation between loss distribution and other goals, of course, is to be found in GUIDO CALABRESI, THE COSTS OF ACCIDENTS 39-54 (1970).

Looking at the subject fifty years later, it is clear that viewing loss distribution as a principal goal of tort law has long been out of academic fashion. This has occurred for two reasons. First, the second half of the 20th century witnessed an explosion of other methods of distributing losses, predominantly in the form of private first-party and social insurance. To many tort theorists, it is not now necessary for tort law to promote loss distribution, whatever the argument for doing so may once have been, because first-party insurance is now performing that task. Second, because of the rise of first-party and social insurance, because it is now less obvious than it once seemed to be that enterprises can easily insure against the risk of civil liability,[3] and for reasons of academic taste, tort theorists have become preoccupied with issues other than loss distribution. Whether and how tort law should promote optimal deterrence occupied the lion's share of tort theorists' attention for the last several decades of the 20th century. Recently, corrective justice and related views have experienced something of a renaissance in academic circles.[4] The attention paid to deterrence and corrective justice, and to the proper role of each within tort law, has largely crowded out concern with loss distribution.

Regardless of whether academics consider loss distribution to be an important goal of tort liability, however, loss distribution issues cannot be avoided in thinking about tort. In practice the tort system has been anything but indifferent to loss distribution. The major expansions in the incidence and scope of liability that occurred in the 1970's and 80's can be ascribed at least in part to loss distributional aims. The same can be said of the consistent

[3]See Kenneth S. Abraham, *The Rise and Fall of Commercial Liability Insurance*, 87 VA. L. REV. 85 (2001).

[4]*See, e.g.*, JULES L. COLEMAN, RISKS AND WRONGS (2002); ERNEST J. WEINRIB, THE IDEA OF PRIVATE LAW (1995); John C.P. Goldberg & Benjamin Zipursky, *Unrealized Torts*, 88 VA. L. REV. 1625 (2002).

increases in real tort costs from that period to the present,[5] as well as the continued willingness of contemporary courts to maintain the legal precedents that helped to generate the expansion of products and mass tort liability during the past few decades.[6] Achieving loss distribution through tort may have largely vanished from academic radar screens, but it is still alive in the actual practices of tort law.

Moreover, even we were able to rule out purposely shaping the scope of liability rules to achieve greater loss distribution, tort must have a method of addressing the relationship between its own liability and damages rules and the vast range of sources of compensation for personal injury and illness that operate outside of tort. These "collateral" sources, comprised largely of private first-party and social insurance, have almost always already provided tort claimants with some compensation, and often with very substantial compensation, by the time a tort case finally comes to be tried or settled. The payment of additional benefits to claimants by these sources is also often in prospect for those with continuing or permanent injuries. Whatever rule governs the relationship between tort damages and these other sources of compensation inevitably will have a loss distributional (or antidistributional) impact. Tort must therefore confront the question of how it will deal with these sources, as well as the loss distributional impacts of the options that are available.

Naturally enough, tort law's traditional approach to its relation to collateral sources has been termed the "collateral source rule." But in fact there are at least four possible collateral source rules, each with its own approach to the treatment of benefits paid or payable by

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[5] *See* Tillinghast-Towers Perrin, U.S. Tort Costs: 2003 Update 12 (hereinafter "U.S. Tort Costs.")

[6] *See* Gary L. Schwartz, The Beginning and Possible End of the Rise of Modern American Tort Law, 26 GA. L. REV. 601 (1992).

collateral sources, and each with corresponding loss distributional effects and implications. In this Chapter I examine these effects and implications, in an effort to make sense out of the relation between tort liability and the disparate world of first-party and social insurance. I argue that, because tort liability is a comparatively poor method of distributing losses, we should reshape the relationship between tort liability and collateral source payments. First-party insurance policyholders and social insurance beneficiaries, who are all of course potential plaintiffs in personal injury litigation, should be permitted to transfer all their tort rights to their first-party insurers, in return for lower premiums or more generous coverage. This "full-subrogation" approach would preserve the deterrent effect of the threat of tort liability, but at the same time enhance the possibilities for loss distribution through forms of insurance that are superior to tort because they pay a higher percentage of their expenditures to victims and provide more certain recovery. Because the approach would be optional rather than mandatory, it would not put the state in the business of deciding the proper mix of tort rights and insurance for all individuals. Rather, individuals would be permitted to make this decision for themselves.

In order to place tort law in an insurance perspective, Part I surveys and quantifies the magnitude of the different sources of compensation for personal injury, illness, and death. This survey locates tort liability within our larger "system" of compensation and compares its functioning and scope with the other methods of loss distribution that are employed by the system. This survey reveals the extent to which there is in fact a vast system of loss distribution, of which tort is only a small part. On the other hand, that system is by no means comprehensive; it contains important gaps. The central issue is whether these gaps should be filled by tort or by the other sources, and how that might be accomplished.

To address this issue the Chapter then turns to the relationship between tort and the rest of the loss distribution system. Part II analyzes the different possible relationships by identifying and exploring the loss distributional and other impacts of four possible variants of the collateral source rule. My conclusion in this Part is that none of these variants satisfactorily reconciles the tension between tort law's deterrence goal and its comparative ineffectiveness at loss distribution. Finally, Part III looks at the rarely-considered, distinct treatment accorded to life insurance and savings under existing rules, and then recommends the full-subrogation approach to tort law's treatment of collateral sources, in order to retain tort law's deterrence potential but enhance overall loss distribution.

I. THE TORT SYSTEM IN INSURANCE PERSPECTIVE

Lawyers and academics are tortcentric.[7] We tend to think of the tort system as the center of the personal injury and illness universe, whereas – as I will show below – in quantitative terms tort is only a minor player in this universe. As lawyers we are inclined to think naturally in terms of lawsuits, not insurance or compensation programs. We read cases, we litigate cases, we derive the rules upon which we base legal advice from cases. Private and social insurance generally lie at the periphery of this world of litigation and judicial decisions. The primary domain of insurance is instead a set of abstruse contracts that typically are not read by policyholders, or obscure and bureaucratic regimes such as social security, whose contours are vague until the time comes to apply for the benefits they provide. Ask the average lawyer what her rights would be if she were injured by a negligent driver, and she will have a pretty good idea of the correct answer. Ask her what she would receive from social security and under what

[7] *See* Richard B. Stewart, *Crisis in Tort Law? The Institutional Perspective*, 54 U. CHI. L. REV. 184 (1987).

circumstances she would receive it if she became disabled, and the chances are she would draw a blank. One consequence of this differential awareness, I think, is that as lawyers we tend to overrate the importance of tort, both as a method of deterring unsafe conduct and as a source of compensation, and to underrate the other methods of promoting safety and compensating the victims of illness and injury.[8]

In a sense this is because tort is unique in its features. Tort liability is the only significant device we employ specifically to compensate the victims of third-party wrongdoing. In another sense, however, tort is just one component of a larger system of compensation for personal injury and illness. Viewing tort not in isolation from this larger system, but as a part of it, helps to reveal tort's comparatively modest scope. The sheer amount of money spent each year to compensate the victims of injury and illness tell a story that words alone do not adequately capture.[9]

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[8]There are other reasons for this tortcentricity as well. The central place that the course in Torts has played in the law school curriculum for over a century, and continues to play today, has a profound influence on the legal consciousness. Torts occupies its honored place in the first year of law school partly out of intertia, partly because it is as good a subject as any to provide the basis for teaching about the common law and the legal process, and partly because it provides a template for thinking about the non-contractual (and non-tort) civil liabilities that are the subject of more advanced courses in the curriculum. Many of these subjects – securities law, employment discrimination, even copyright – depend on the notions of duty, breach, damage, and causation that form the conceptual framework for what is studied in the first-year Torts course. In this sense it is not tort law itself but these tort law concepts that are the necessary building blocks in a legal education. In addition, areas other than Torts in which the law also does the work of compensating injury or promoting safety do not receive nearly the same curricular prominence. Courses in safety regulation are divided by medium -- environmental law or food and drug law, for example. And in most law schools today there is no course at all on product safety regulation, though there is sometimes a course on products liability law. On the compensation side the curriculum is also lean, as well as divided. Courses on insurance are no longer rare, but neither are they prominent in most law schools. And they are virtually always about private insurance alone. Public or social insurance receives little attention in the typical law school's curriculum, and when a course does address the subject it is often from the perspective of welfare or proverty policy, without much emphasis on compensating for injury or illness. Workers compensation receives even less attention. Only twenty-two individuals were reported to be teaching a course on Workers Compensation in an American law school during the year 2003-04. *See* THE AALS DIRECTORY OF LAW TEACHERS 1442-43 (2003).

[9]Unfortunately, the most recent year for which cost and benefits-paid data is available varies, depending on the compensation source or program in question. I have chosen to use data from the latest year available for each source or program, in order to provide the most accurate picture of each separate source or program as is possible.

(1986).

Tort. The total direct cost of the tort system is roughly $233 billion per year. This is a more than 100 fold increase since 1950, when tort costs were about $2 billion. The increase in tort costs during this period has outstripped economic growth by a factor of 3.[10] Not all of this sum, however, is paid on account of losses associated with personal injury and illness. Some portion of the total is paid in connection with claims for property damage, for pure economic loss, and for losses associated with dignitary torts such as defamation and invasion of privacy. For the sake of simplicity I will assume conservatively that 75 percent of the $233 billion annual cost of tort is the result of claims for personal injury and illness. Consequently, the proper figure to keep in mind for purposes of comparison with other sources is a direct tort cost of $175 billion.

The percentage of this sum that is paid to personal injury and illness victims cannot be pinpointed exactly. One recent estimate is that only 46 percent of all expenditures, which based on the above calculation amounts to about $80 billion per year, is paid to victims.[11] There is also somewhat less recent data on particular sub-fields within tort. Only a bit more than half of all money expended on automobile liability goes to victims,[12] In contrast, products liability and medical malpractice pay a considerably smaller portion of their expenditures to

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As a consequence, in comparing sources and in estimating the total costs of compensation paid by the system as a whole, my survey adds together or compares data from different years for different sources. Given the hundreds of billions of dollars involved and the relatively modest changes that occur from year to year, however, the inaccuracy that results is probably minimal.

[10]All this data can be found in U.S. Tort Costs, *supra* note 5, at 1.

[11]*See id* at 17.

[12]*See* JAMES S. KAKALIK & NICHOLAS M. PACE, COSTS AND COMPENSATION PAID IN TORT LITIGATION 72

victims – perhaps as little as one-third.[13]

Only half or even less of what we spend on tort is paid to victims, of course, because the system spends a great deal for the individualized fact-finding regarding negligence, causation, and damages that are so characteristic of tort. The theory of corrective justice requires monetary awards that are carefully tailored to the evidence of each particular plaintiff's past and probable future losses, both economic and emotional. And the search for optimal deterrence dovetails with this individualized tailoring of awards. To achieve deterrence the system must strive to threaten and to impose liability on defendants for all, but no more than all, of the costs that their negligence causes. Making this determination can be costly. In this respect the two approaches that compete for the dominance of tort theory converge, both requiring that a considerable portion of the tort dollar be spent on the cost of administration rather than on compensation itself.

Workers' Compensation. Workers' compensation pays benefits for injuries "arising out of or in the course of employment." Benefits paid by this nonfault system of compensation for job-related injuries are lower than those paid by tort, $46 billion as compared to tort's $80 billion.[14] Because workers compensation is essentially a system of absolute liability on the part of the employer, however, fact-finding as to liability is usually unnecessary. As a consequence, the cost of administration related to that issue is generally low. Therefore, workers compensation pays a much higher percentage of the total dollars it expends in benefits than does

[13] *See* COMMITTEE FOR ECONOMIC DEVELOPMENT, WHO SHOULD BE LIABLE? 53 (1989) (estimates of 35-45 percent); STEPHEN D. SUGARMAN, DOING AWAY WITH TORT LAW 23-24 (1989) (citing estimates of 37-40 percent).

[14] *See* UNITED STATES BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 352, Table 532 (2002) (hereinafter "STATISTICAL ABSTRACT").

tort – over 82 percent.[15]

Although benefit levels vary from state to state, typically injured workers are paid all their medical costs. However, wage protection is limited. Most states limit payment to about 2/3 of the employee's weekly wage, and then up to a maximum of $15,000 to $20,000 per year. Lump sum payments for specified permanent disabilities are also paid.

[15] *Id*. (calculated by comparing benefits paid to total expenditures).

Health Insurance. By far the largest non-tort source of compensation for personal injury and illness is health insurance. Health care costs in the United States exceed $1.1 trillion per year.[16] Third-party payments made for direct health care costs (as distinguished from medical research, etc.) total about $846 billion per year, of which payments by public sources such as Medicare, Medicaid, and other smaller programs account for $423 billion,[17] and private insurance for roughly the same amount.[18] Together these sources pay about 79 percent of all personal health care expenditures,[19] leaving individuals to pay $194 billion per year themselves.[20] A significant portion of these personal expenditures is incurred by persons with no health insurance or inadequate insurance: about 15 percent of the population has no health insurance at all.[21]

Life Insurance. Life insurance is also a significant method of loss distribution.

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[16]*Id*. at 92, Table 113.

[17]*Id*. at 340, Table 510.

[18]*Id.* at 92, Table 113. The remaining third-party-paid funds are paid by non-patient revenues and other sources. *Id*., n. 1.

[19]*Id*.

[20]*Id*. All but a very small proportion of the cost of hospital care is insured, whereas nearly one-fifth of the cost of ambulatory care is paid by individuals. U.S. Census Bureau, Report No. P60-215: Health Insurance Coverage 2000, Tables 3-5 (in 1997, 2.6 percent of the cost of hospital care and 17.3 percent of the cost of ambulatory care was paid for out-of-pocket). Private insurers pay about 95 percent of the premium dollar in benefits. *See* STATISTICAL ABSTRACT, *supra* note 14, at 93, Table 113 and 93, Table 117 (calculated by comparing total benefits paid of $423 billion to total premiums of $444 billion). Payout ratios for all the public sources cannot easily be calculated because of their methods of accounting, but the ratio for the largest – Medicare – is similar at 96 percent. *Id*. at 92, Table 113, and 340, Table 511 (calculated by comparing total benefits paid of 215 billion to total expenditures 224 billion). These comparatively high payout ratios are not achieved because health insurers and government bureaucrats necessarily do their jobs efficiently, but because of the nature of these compensation systems. Since a right to health insurance benefits is triggered by the mere occurrence of a health care expense, the determination of eligibility and the proper amount of payment is largely a clerical rather than a fact-finding function.

[21]*Id*. at 102, Table 137.

The average insured household is covered by nearly $200,000 of life insurance.[22] Fixing the proper of amount of life insurance benefits to figure into the calculus requires some estimation, however, because life insurance represents both insurance and savings. Each year over $44 billion is paid to the beneficiaries of life insurance policyholders as death benefits.[23] But an additional $31 billion is paid as living benefits, in the form of cash surrender or investment return.[24] An indeterminate portion of this sum is undoubtedly used by recipients to cover injury and illness costs.

Life insurance has sometimes been considered to be payment to assuage grief. But it is more accurate and useful to conceive of life insurance as compensation for loss of earning power or human capital. A household that purchases insurance on the life of its principal income earner is not buying protection against grief; rather, it is insuring against the possibility that it will be deprived of support by the premature death of the insured. Life insurance is therefore best understood mainly as a method of compensating for income lost because of death resulting from illness or injury.[25] On this view, although $200,000 may seem like a significant amount of insurance, it is in fact inadequate protection against lost income for virtually all families – at current interest rates this sum would yield an annual income of less than $10,000.

Disability Insurance. The majority of payments for disability -- income lost

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[22] AMERICAN COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 117, Table 7.14 (2001) (hereinafter "LIFE INSURERS FACT BOOK 2001")

[23] AMERICAN COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 75-77 (2002).

[24] *Id*.

[25] *See* Kenneth S. Abraham and Kyle D. Logue, *The Genie and the Bottle: Collateral Sources under the 9/11 Victims Compensation Fund* 54 DE PAUL L. REV. __ (2004).

because of the inability to work – are made by the Social Security Disability program. This program pays about $55 billion per year for total, long-term disability.[26] But the average monthly benefit is only $814 to each disabled beneficiary and $238 to children of disabled beneficiaries.[27] Statistics on benefits paid by privately purchased long-term disability insurance are difficult to obtain, because these payouts are comparatively small – I estimate that they are on the order of $10 billion per year.[28] Roughly 25 percent of private sector employees have long term disability insurance -- though the discrepancy in the percentage of individuals in different wage groups who are covered is striking. Whereas 47 percent of white-collar employees are covered, only 13 percent of blue collar employees are.[29] In addition, benefits paid for short-term disability, in the form of paid sick leave, are available to about one-half of the work force.[30] Based on the data available, my very rough estimate is that the magnitude of these payments is $23 billion per year.[31] Thus, payouts from all these forms of disability coverage total about $88 billion

[26] *See* UNITED STATES BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 345, Table 526 (2001).

[27] *Id*. at 346, Table 519.

[28] *See* LIFE INSURERS FACT BOOK 2001, *supra* note 22, at 137, Table 9.1 (over $13 billion in private disability insurance was in force in 2000); Kenneth S. Abraham and Lance L. Liebman, *Private Insurance, Social Insurance, and Tort Reform: Toward a New Vision of Compensation for Illness and Injury*, 93 COLUM. L. REV. 75, 82 (estimating payments of $6 billion in 1988).

[29] National Academy of Social Insurance, 1996 Disability Panel Interim Report, 33-34. Part of the explanation for this discrepancy is that because the disability protection afforded by workers' compensation and social security covers a much higher proportion of the typical blue collar worker's potential loss of income, such workers have less need for additional, private coverage.

[30] *See* JERRY L. MASHAW AND VIRGINIA P. RENO (ED.'S), THE ENVIRONMENT OF DISABILITY INCOME POLICY: PROGRAMS, PEOPLE, HISTORY AND CONTEXT 34 (1996).

[31] Sick pay costs are about $.17 for every $15.80 in wages and salaries paid, or about 1.1 percent of pay. STATISTICAL ABSTRACT, *supra* note 14, at 406, Table 618. The mean hourly wage of U.S. workers is $16.35. Bureau of Labor Statistics, Occupational Employment Statistics 2001, available at http://www.bls.gov/oes/2001/oes_00al.htm. If we assume an average of 40 hours per week of work for 52 weeks each

annually.[32]

Putting these figures together, as reflected in Table I, yields a rough idea of the quantitative importance of tort liability within our broader system of compensation for illness and injury. In very rough terms, that broader system costs about $1.7 trillion annually, of which $175 billion, or about 10 percent, is for personal injury and illness tort costs.[33] Looking at percentages of benefits paid rather than percentages of costs, $1.1 trillion in benefits is paid each year, of which about $80 billion, or just over 7 percent, is paid to the relevant subset of tort victims.

[Insert Table I about here]

Table I
Annual Personal Injury and Illness Compensation Costs
(in $ billions)

	Expenditures	Benefits Paid
Tort	175	80
Workers Compensation	56	46
Health Insurance	1100	846
Health Care Out-of-Pocket	194	--
Life Insurance	48	44
Disability Insurance	96	88
Total	1669	1104

year, worked by the 50 percent of the 127 million workers for whom sick pay is available, see *id*., then sick leave costs to employers are roughly $.18 per hour, or $374 per year for each of about 64 million workers – about $24 billion annually. Assuming about $1 billion in administrative costs yields an estimate of benefits paid per year of $23 billion.

[32] There are a number of other programs, public and private, that pay benefits to the victims of injury and illness. These include the federal childhood vaccine compensation plan; the Florida and Virginia birth-related neurological injury compensation funds; and auto no-fault plans in force in over a dozen number of states. These programs are important conceptually, because -- along with workers compensation -- they reflect an activity-based alternative to the largely fault-based approach of tort. But quantitatively they pay only a few billion dollars per year to victims and therefore are barely visible on the radar screen.

[33] To make this calculation I have assumed that the programs for which I have data only on payouts, but no meaningful or usable data on premiums or receipts, pay about 90 percent of their receipts as benefits.

Thus, tort plays a small role in our system of public and private loss distribution. Tort is also a comparatively inefficient compensation mechanism, in that it pays a much smaller percentage of its expenditures to victims than the other approaches. And because the other approaches compensate on a broader basis, they are superior not only at loss distribution but also at risk distribution. On the other hand, payments made by the overall system are far from sufficient to compensate all the victims of illness and injury for all their losses. Although there is therefore at least a potential a role to be played by tort in filling the gaps in our overall loss distribution system, the question is whether expanding tort or the features of our broader system of compensation is the better method of addressing this problem.

II. THE RELATION BETWEEN TORT AND FIRST-PARTY AND SOCIAL INSURANCE

There can be little question that, whatever might be said about the treatment of collateral sources in tort for loss distribution purposes, optimal deterrence is best served by a rule that ignores these sources in determining the amount of damages for which a defendant is liable. Otherwise defendants are not threatened with liability for the full social cost of their actions. Of the four possible rules explored below, the first three – each a different version of the "nonoffset" approach – serves the deterrence goal. The last, or "offset" approach, is less concerned with deterrence, and instead threatens defendants only with liability for the losses that plaintiffs have actually suffered, net of insurance.

Each of the approaches has different loss distributional consequences. Thus, even if one takes the extremely plausible position that because tort is an inefficient approach to affording compensation its rules should emphasize deterrence, the different loss distributional consequences of the three nonoffset approaches that reflect this emphasis still are worth considering. Similarly, given the criticism that the traditional, nonoffset collateral source rule continually receives at the hands of the proponents of certain versions of tort reform, the distributional consequences of the offset approach should also be considered. Thus, even if loss distribution is ruled out as a major goal of tort, it is not possible to escape thinking about loss distribution in establishing and evaluating tort law's treatment of collateral sources. Perhaps more importantly, examination of each of the existing approaches to the treatment of collateral sources reveals that none of them satisfactorily reconciles the tension between tort law's goal of promoting deterrence and achieving effective loss distribution.

A. The Collateral Source Rule and Insurance Reality

A recurring theme in the tort law literature and in debates about tort reform has been the proper role of payment by collateral sources in determining the successful plaintiff's damages.[34] Should there always be a full award of damages to tort claimants, notwithstanding past or anticipated future payment of benefits to the claimant by these sources, or should the amount of benefits paid to the claimant by collateral sources such as insurance be offset against the award, in order to avoid duplicate recovery?

For almost as long as this theme has existed, however, it has been understood that posing the question in this way is simplistic. When the traditional collateral source rule applies and there is no offset against the award, the plaintiff does not necessarily secure duplicate recovery. Even setting aside the fact that the damages awarded may be incomplete and that contingent counsel fees ordinarily must be paid out of the award, another device is designed to

[34] *See. e.g.*, FOWLER W. HARPER & FLEMING JAMES, JR., 2 THE LAW OF TORTS § 25.22 at 1343-54 (1956);

preclude double recovery: subrogation.[35]

Subrogation is the process by which one party is substituted for another party relative to the latter's rights against a third party. By operation of law or by contract, virtually all forms of private insurance and many forms of social insurance have rights of subrogation, transferring to insurers the policyholder's or beneficiary's right of recovery against third parties, to the extent of payment by the collateral source. For example, a health or workers' compensation insurer that has paid a policyholder's medical expenses is typically subrogated to the policyholder's rights of recovery against a tortfeasor responsible for the injury that generated these expenses.

Although this right of subrogation can in theory be vindicated in a direct action brought by the insurer against the tortfeasor, the more conventional method of vindication is through reimbursement of the insurer of the policyholder out the policyholder's tort recovery. In short, through what I will call "subrogation reimbursement," duplicate recovery by the tort claimant can be avoided. Indeed, in a sense the traditional collateral source rule exists precisely in order to make such reimbursement possible without depriving the policyholder of the potential for obtaining full compensation.

In practice, however, three factors impede this seemingly ordered approach. First, insurers do not always monitor tort suits brought by their policyholders so as to be in a position to vindicate their subrogation reimbursement rights when there is a tort recovery subsequent to the payment of insurance benefits. Doing so over a period of years is costly, and in the case of

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John G. Fleming, *The Collateral Source Rule and Loss Allocation in Tort Law*, 54 CALIF. L. REV. 1478 (1966).

[35] *See* KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 153-56 (1986).

comparatively small potential reimbursement, not necessarily cost effective.

Second, since most cases are settled, an administratively simple method of dividing a settlement that isolates the insurer's proper share of an incomplete pie is necessary, to make it possible for reimbursement to take place automatically. But none of the alternatives is entirely satisfactory, and not all states have clearly specified one.[36]

Third, to function ideally, the system should also permit future subrogation reimbursement. That is, after any claimant has recovered in tort not only for past but also for future losses, the claimant will begin to incur additional out-of-pocket losses as a result of the harm for which she has already received damages from the defendant. A collateral source that then pays insurance benefits to such a claimant should in theory receive subrogation reimbursement from that same claimant, since the claimant has already recovered in tort for some or all of these losses. But whether these future payments are made on account of losses resulting from the prior tort or from an independent illness or injury becomes increasingly difficult and correspondingly more expensive to determine as time progresses. Accounting for the benefits paid and the subrogation reimbursement due also would be bizarre. It is difficult to imagine a health insurer paying for a policyholder's medical care and then billing the policyholder for reimbursement to the extent that the care had been provided on account of an injury for which the policyholder had already received a tort recovery.

For these reasons among others, it is common for health and disability insurers who are about to receive subrogation reimbursement at the time of a tort recovery to waive any right they have to future reimbursement, in return for present reimbursement. But of course these

[36] For an illustration of the problems that arise in fashioning such a method, see Associated Hospital Service

particular insurers will not necessarily be the insurers of the claimant at all times in the future, and the claimant's future insurers are not bound by such a waiver. Especially in cases involving severe, permanent injury, in which a substantial portion of the recovery awarded to the plaintiff may be for future out of pocket losses, the potential for subrogation reimbursement to fail in this major way is significant.

Thus, for a variety of reasons, although we must take the possibility of subrogation reimbursement into account in considering the distributional consequences of different approaches to the treatment of collateral sources in tort, we should also recognize that subrogation theory and subrogation reality may differ, and sometimes substantially.

B. The Loss Distributional Choices

Modern tort law has developed two different general arrangements for dealing with collateral sources. The traditional, or *nonoffset*, approach is known as the "collateral source rule," and denies the tortfeasor any credit for benefits paid or payable to the plaintiff by collateral sources. Subrogation reimbursement by collateral sources is then permitted to ensure that the plaintiff does not secure any duplicate recovery. The alternative *offset* approach enacted in a minority of states provides the tortfeasor with a credit that reduces the plaintiff's tort recovery by amounts paid (and sometimes payable) by collateral sources.

Under these two approaches the issue is not whether to avoid duplicate compensation – both nonoffsets linked with subrogation reimbursement and offsets have the potential to achieve that goal. Rather, the issue is which party should be the primary cost bearer – the tortfeasor and its liability insurer, or loss-based sources of insurance. If tort damages are

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of Philadelphia v. Pustilnik, 396 A.2d 1332 (Pa. Super. 1979).

offset by payments from loss-based sources, then these latter sources are primary insurers. If there are no offsets, then the tortfeasor and its liability insurer are primary insurers, because they pay in full and the plaintiff's collateral sources receive reimbursement for their payments out of the tort award.

But it turns out that these are merely general categories. There are in fact potential variations that yield four different possible treatments of the relation between tort recoveries and the benefits that are paid or payable by collateral sources. The different approaches that are available have quite different impacts on the distribution of loss. The following examination of these approaches begins with the nonoffset approaches, and within this category moves from the variation that is most generous to tort claimants and least advantageous to nontortiously-harmed victims, to the variation that is least generous to tort victims and most advantageous to nontortiously-harmed victims. It then explores the alternative, offset approach.

1. Nonoffsets without Collateral Reimbursement

The broadest existing approach for using tort law's treatment of collateral sources for loss distribution purposes is to preclude offsets through the traditional collateral source rule, but also to preclude subrogation reimbursement of first-party and social insurance sources. This is the approach that has always applied to life insurance, and largely to life insurance alone.[37] Applied more broadly, this approach would maintain the traditional rule's focus on ensuring that the cost of tortiously-caused loss is channeled through the tortfeasor or its liability insurer. At the same time, however, this approach would recognize that because most tort recoveries are partial,

[37]Though rare in connection with other forms of insurance, this approach is occasionally prescribed by statute applicable in other limited contexts. *See, e.g.,* Ann. Code of Md.§ 19-109 (2002) (prohibiting subrogation by insurers providing medical payments coverage under auto insurance policies).

even the plaintiff's tort recovery plus her first-party insurance and benefits may not provide full compensation.

Tort recoveries are often incompletely compensatory in part because the contingent-fee system almost automatically produces under-compensation for any claimant who recovers less than her full losses by judgment or settlement. In the aggregate, the sums paid by plaintiffs as counsel fees are equal to seventy-nine percent of the awards for non-economic loss net of counsel fees.[38] When a contingency-based counsel fee is subtracted from full, or much more often, from partial recovery, the claimant is therefore likely to be undercompensated. Thus, the majority of victims, who settle for less than their full losses, probably are left less than fully compensated for their out-of-pocket losses even before paying any subrogation reimbursement they owe to their health or disability insurers.

In addition, a high percentage of all tort claims -- certainly over 90 percent -- are settled. Virtually by definition the claimants in these cases receive less than full compensation. There may well be a certain amount of "excess" compensation that claimants who settle have been paid by collateral sources that is not ultimately returned to insurers because of the shortfalls in enforcement of subrogation reimbursement to which I referred earlier. But in the aggregate this excess is likely to be more than offset by the payment of counsel fees.[39] In short, many claimants probably do not recover even their full economic losses, and those that do recover these losses in

[38] *See* U.S. TORT COSTS, *supra* note 5, at 17 (claimants' attorneys fees constitute 19 percent of total tort costs, while awards for noneconomic loss constitute 24 percent).

[39] Since total payments for economic loss net of counsel fees are only slightly greater than amounts paid for counsel fees, *see id.* (awards for economic loss constitute 22 percent of total tort costs; awards for claimants' counsel fees constitute 19 percent), counsel fees are likely to exceed the amount of the claimant's prior collateral source payments that are not reimbursed to the insurer.

full probably succeed in doing so only if they are not forced to reimburse their health and disability insurers out of their recoveries.

There are three distributional objections, however, to institutionalizing a no subrogation reimbursement rule to go along with the nonoffset approach. First, this approach would favor tort victims at the expense of victims of nontortiously-caused injury and illness. Subrogation reimbursement is a means by which premium levels or costs for first-party and social insurance are contained. Denying these sources reimbursement would provide a benefit to the minority of policyholders or beneficiaries who suffered tortiously-caused injury, but only by disadvantaging the majority whose losses are not tortiously-caused, by increasing their premiums or reducing the amount of coverage that would otherwise be available to them.

Moreover, as we saw in Part I, tort is a comparatively expensive way to provide insurance against loss, paying at most only 50 percent of all of its expenditures to victims. Those who pay tort "premiums" as part of the price of products or health care would rationally prefer to use those premiums to buy more first-party insurance rather than tort insurance. That would provide more actual insurance for the money. In addition, first-party insurance provides more of the kind of insurance that individuals rationally would prefer. First-party insurance provides a more certain payoff than tort and it provides a payoff of out-pocket-expenses only. Ordinarily, suffering a nonpecuniary loss does not alter an individual's need for money. From an insurance standpoint, therefore, more than a modicum of tort insurance against nonpecuniary loss, or pain and suffering, is not a sensible purchase for most people.

Second, denying insurers subrogation reimbursement would accord a priority to compensating for intangible loss rather than first ensuring compensation for out-of-pocket loss resulting from illness or injury. That is, the compensation shortfall experienced by some claimants means at least in part that reimbursing their insurers for already-paid out-of-pocket loss deprives the claimants of some or all of their pain and suffering damages. Denying insurers reimbursement would result in an increase in the cost of first-party insurance, in order to permit claimants to keep these pain and suffering damages. In effect, potential tort victims would be paying their first-party insurers a premium for the right to retain all the pain and suffering damages they recovered. For the reasons specified earlier, this is probably not a purchase most policyholders rationally would or should want to make.[40]

Third, a no-reimbursement rule would in effect charge first-party policyholders an additional premium for the chance of recovering more than their net losses in the event that they were tortiously injured and were fully compensated in tort. A claimant fully compensated in tort but without any subrogation reimbursement obligation would double-recover at least some out-of-pocket losses. First-party insurance premiums would rise, because the absence of subrogation reimbursement would decrease insurer revenues. This would amount to the mandatory purchase by policyholders of a lottery ticket that would pay off if they were tortiously injured and brought completely successful tort suits. This would not constitute insurance, however, which distributes the risk of suffering loss, but a gamble that would provide the chance of obtaining a net financial gain as a result of being tortiously harmed. A rational purchaser of insurance would not want to spend money on this kind of gamble.

2. Nonoffsets with Collateral Reimbursement Subject to a Make-Whole Constraint

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[40] For an argument to the contrary, see Steven D. Croley & Jon D. Hanson, *The Nonpecuriary Costs of Accidents: Pain and Suffering Damages in Tort Law*, 108 HARV. L. REV. 1785, 1812-34 (1995) (arguing that under certain conditions consumers might desire to insure against pain and suffering).

This is a version of the traditional collateral source rule precluding offsets, but with a qualification that is added in some jurisdictions. Under this variation, collateral sources have no right of reimbursement until the plaintiff has been made whole.[41]

The crucial feature of this "make-whole" requirement is its treatment of pain and suffering damages. Typically a prerequisite to the insurer's right to subrogation reimbursement under the make-whole rule is that the plaintiff have been fully compensated for both out-of-pocket and intangible loss.[42] In such cases the make-whole constraint precludes reimbursement virtually every time a case has settled, as well as in cases tried to judgment in which the defendant had a partial defense such as comparative negligence. For practical purposes, therefore, this approach tends to preclude subrogation reimbursement in most cases, and is subject in these cases to the objections detailed in the preceding section.

On the other hand, if – as tends not to be the case – compensation for pain and suffering were excluded from the make-whole calculation, then the make-whole constraint would establish tort as a gap-filler, providing compensation for out-of-pocket loss in precisely those cases in which a plaintiff's first-party insurance was insufficient to cover all such loss. Since in the aggregate the amount of pain and suffering damages retained by plaintiffs after paying counsel fees is roughly equal to counsel fees themselves, the make-whole constraint would generally enable plaintiffs to retain the amount of any recovery of uninsured damages for out-of-pocket loss that was still left after paying counsel fees, plus perhaps some pain and suffering damages as well.

[41] *See.,e.g.*, Duncan v. Integon General Ins. Corp., 482 S.E.2d 325 (Ga. 1997). *See also* Elaine M. Rinaldi, *Apportionment of Recovery between Insured and Insurer in a Subrogation Case*, 34 TORT & INS. PRAC. J. 803 (1994).

[42] *See, e.g.*, Rimes v. State Farm Automobile Ins. Co., 316 N.W.2d 348 (Wis. 1992).

This approach would meet some but not all of the objections to non-reimbursement analyzed earlier. It would not risk overcompensating for out-of-pocket loss. And any first-party insurance premium increases occurring on account of the make-whole constraint on subrogation reimbursement would be paid so as to ensure full recovery of out-of-pocket loss rather than to enable the policyholder to retain pain and suffering damages. However, like the blanket prohibition on subrogation reimbursement, the make-whole constraint privileges tort claimants at the expense of victims of nontortiously-caused injury and illness, whose first-party insurance premiums are higher than they would be in the absence of the make-whole constraint on subrogation reimbursement. The effect is therefore to give priority to expensive loss distribution through tort, rather than less expensive and therefore more loss-distributive first-party and social insurance.

Moreover, the administrative complications associated with a make-whole constraint on subrogation reimbursement can be substantial. The problem is how to determine whether the plaintiff was or was not made whole, regardless of the conception of being "made whole" that is employed. Note first that this problem would not arise in cases in which there had been no reduction in damages because of comparative negligence or a similar defense and the case was tried to a verdict. By definition these are cases in which the plaintiff has been or at least could be treated as having been fully compensated for her losses. But no such presumption could be made in cases involving reduced verdicts; only if all cases were required to employ special verdict procedures could the verdict reveal whether and to what extent the make-whole constraint had been satisfied.

More importantly, the vast majority of tort claims are compromised through settlement. One of the main advantages of a settlement is that it avoids the need to adjudicate the amount of the plaintiff's losses. But only by knowing each category as well as the total amount of the plaintiff's losses can the amount that has as yet been uncompensated be determined. So the consequence of a make-whole rule is that, after every tort case that is settled, the damages portion of the case may have to be litigated anyway, in order to determine whether the plaintiff has been made whole. This can be done in something less than a full-scale damages trial. But an adjudicative proceeding of some sort, with all the expense entailed in fact-finding and possibly substantial discovery, is necessary.[43] Thus, any appealing features of even the modified make-whole rule that I have described above would require further complicating and thereby rendering more expensive the resolution of most tort claims.[44]

3. Nonoffsets with Off-the-Top Collateral Reimbursement

Under this approach the plaintiff is entitled to full recovery in tort regardless of payments made by collateral sources,[45] but those sources are entitled to subrogation reimbursement off-the-top of tort judgments or settlements, regardless of whether this will deprive the claimant of full compensation -- i.e., keep the claimant from being made whole.

By returning more money to first-party insurers than the make-whole approach, in

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[43] For somewhat anedotal but nonetheless suggestive evidence that, in order to avoid this problem, in practice the insured, the insurer, and plaintiff's counsel often agree on an even, three-way split of settlements, *see* Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action*, 35 LAW & SOC'Y Rev. 275, 304-08 (2001).

[44] A variation on this approach that is occasionally applied, though to settlements only, apportions the settlement between the insurer and insured in the proportion that the amount the insurer has paid to the policyholder bears to the policyholder's total loss. See ALAN I. WIDISS AND ROBERT E. KEETON, INSURANCE LAW §310 (b)(1) at 234 (1988). The fact-finding difficulties entailed in this approach parallel those posed by the make-whole approach.

[45] See Restatement of Torts (Second) § 920A(2) (1979).

the aggregate this approach either permits the purchase of more first-party insurance than would otherwise be available, or reduces the cost of premiums. This approach thus gives all policyholders, rather than merely tort claimants, this advantage. As a matter of loss distribution this benefits more people and at lower cost than the preceding two nonoffset approaches. There is admittedly still some administrative cost entailed in accomplishing subrogation reimbursement, since it involves the cost of collection by first-party and social insurers. But this cost is lower than under the make-whole rule, which requires fact-finding as to the proper amount of reimbursement in addition to the cost of collection. In contrast, under the off-the-top approach the proper amount of reimbursement is always a specified sum – the full amount the insurer has paid to or on behalf of the claimant.

In short, the rule embodied in this variation preserves the deterrence-promoting potential of any nonoffset rule, but also channels more loss distribution resources through first-party and social insurance than the other nonoffset variations. It does this at comparative sacrifice in the net compensation of tort victims, in effect tolerating potential undercompensation in tort in return for enhancing loss distribution through these other, more cost-effective methods of distributing loss.

4. Offsets with No Collateral Reimbursement

I now turn to the offset approach, which reduces the amount of the plaintiff's tort recovery by benefits paid or payable from first-party and social insurance sources. This approach sacrifices potential deterrence in return for eliminating the risk that the plaintiff will be overcompensated through the combined receipt of first-party insurance and tort damages. It also avoids the cost of collecting subrogation reimbursement.

This approach has been enacted by statute in a minority of states, thus reversing the traditional collateral source rule.[46] Under this approach any sum that has been paid or (often) that will be payable in the future by collateral sources is offset against the plaintiff's tort recovery. The plaintiff therefore recovers in tort only the difference between the amount paid or payable by collateral sources and her total losses. To the extent that the plaintiff is fully insured for out-of-pocket losses, then, her tort recovery consists exclusively of pain and suffering damages. Only to the extent that the plaintiff is underinsured does she recover out-of-pocket losses in tort. In effect tort is a gap filler under this approach, "topping up" the plaintiff's total recovery to ensure full compensation. To make tort truly gap-filler only, first-party and social insurers therefore have no subrogation reimbursement rights under this approach. This approach is thus a rough mirror image of the nonoffset variation that is subject to a make-whole constraint, under which first-party and social insurance "top up" tort recoveries.

From a loss distribution standpoint alone, this approach more sensibly uses tort as a secondary source of compensation rather than as a primary source as is done under the nonoffset approach. But of course this is just a complicated way of saying that tort is a comparatively inefficient insurance mechanism, and of underscoring that it is mainly the non-distributional purposes of deterrence and corrective justice that lie behind the nonoffset approaches.

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[46] *See, e.g.*, N.J. Stat. §2A:15-97 (2003); Mont Code Ann §27-1-308 (applicable to actions for injury or death where total award exceeds $50,000). Some states apply this approach only where a collateral source has no subrogation rights, thus adopting the traditional rule for sources with subrogation rights and the offset rule for sources without such rights. *See, e.g.*, Conn. Gen. Stat. § 52-225(a) (2003).

Perhaps more importantly, once it is recognized that the sums paid as counsel fees tend to be roughly equal to the amount pain and suffering damages that plaintiffs retain,[47] the underlying political motive behind the enactment of this approach comes into view. The plaintiff is likely to bring a tort action under this approach only if she has substantial uninsured out-of-pocket expenses or the potential for recovering substantial pain and suffering damages. Otherwise she will be unable to find counsel willing to take the case on a contingent-fee basis, since potential recovery will be prohibitively small. So whatever its loss-distributional effects, the actual motive behind this approach is to obtain tort relief for potential defendants.

[47] *See* U.S. Tort Costs, *supra* note 5, at 17.

Interestingly, however, by making tort merely a gap filler in this way, the offset approach also reduces the income regressive effect of certain forms of tort liability. In contract settings that may give rise to tort liability, the *de facto* tort "premium" paid as a component of product or health care prices, for example, is not calibrated to the probable amount of income loss that the purchaser will incur if she is injured by a defective product or by medical malpractice.[48] The result is that both comparatively poor and comparatively wealthy purchasers pay the same "tort insurance premium" as part of the price of products or of health care, but the wealthier claimants get more tort insurance for that same premium because they are more likely to have higher income loss than the poor when they are injured. The effect is therefore that compensating for lost income through tort has an income regressive impact. The lesser role that is left for tort by the offset approach reduces this effect, since the effect is mitigated or eliminated by first paying for income loss out of first-party and social insurance, whose premiums are more proportional to the amount of income loss insured and therefore much less (or not at all) income-regressive than tort.

Finally, although the effect of this approach is to employ a make-whole norm with tort as only a secondary source of payment, the approach does not create the same fact-finding difficulties or corresponding expense that the make-whole constraint creates under the nonoffset approach, which makes tort the primary source of payment. Because first-party insurers are not entitled to any subrogation reimbursement under this approach, there is no need for any adjudicatory proceeding in cases involving verdicts reduced because of defenses such as

[48]*See* George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1558-59 (1987); David Rosenberg, *The Causal Connection in Mass Exposure Cases: A "Public Law" Vision of the Tort System*, 97 HARV. L. REV. 851, 918-19 (1984).

comparative negligence, or in settled cases, in order to determine the share to be recovered by first-party insurers. Rather, juries are instructed to apply offsets (or to find the facts necessary for the court to apply them), and presumably settlement occurs in the shadow of the rule that offsets will be applied in any case that goes to judgment. The make-whole norm under an offset approach is in this sense self-applying.

III. Toward a New Treatment of Collateral Sources

We now have several aspects of the loss distribution issue on the table: 1) the scope of our tort and first-party and social insurance systems; 2) the gaps in first-party insurance that sometimes appear to make employing tort for loss distribution purposes appealing; 3) the different ways in which these two parts of the system may relate to each other; and 4) the loss distribution implications of these different possible relations. Still missing, however, is a sense of how one important form of coverage, life insurance, figures in the picture.

In fact, life insurance is wholly exempt from the treatment that other sources receive; as I noted earlier, the nonoffset-without-collateral-reimbursement applies almost exclusively to life insurance. Once we consider treating life insurance in the same manner as all other collateral sources, however, then none of the four possible collateral source rules seems satisfactory. An alternative approach, which would transfer not only a right of reimbursement, but all the tort claimant's rights to first-party insurers, then begins to be attractive.

A. Life Insurance: No Longer a Special Case

Life insurance has always fallen outside the scope of both the majority and minority approaches to collateral sources. For tort law, it is as if life insurance simply did not exist.

The majority approach to the treatment of all other collateral sources involves nonoffsets in tort, with subsequent collateral reimbursement for most sources. Life insurers have no equitable rights of subrogation[49] and never provide for subrogation rights by contract. Consequently, tort claimants have no obligation to reimburse their life insurers out of tort recoveries or settlements. True duplicate recovery – rather than the only apparent duplicate recovery that occurs prior to the subrogation reimbursement of health and disability insurers out of tort recoveries – may actually occur as a result of this arrangement. Correspondingly, in the minority of jurisdictions that take the offset approach to other collateral sources, life insurance benefits are always exempted from the required offset.

This seemingly anomalous treatment of life insurance is, I think, the legacy of two factors. First, the courts long treated life insurance as though its purpose was to assuage grief rather than to indemnify future economic loss. But few families can afford or find it rational to spend current dollars protecting against the risk of suffering future grief. So in fact life insurance is purchased primarily to provide income replacement upon the death of a family's income earner. Nonetheless, because traditionally the courts made equitable subrogation available only to indemnity insurers – that is, only to insurers who insured against out-of-pocket losses – life insurers were never permitted this form of subrogation reimbursement out of tort recoveries in the absence of policy provisions granting them this right.[50]

Second, although the courts might well have permitted life insurers to provide for

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[49] *See, e.g.*, Spencer L. Kimball and Don A. Davis, *The Extension of Insurance Subrogation*, 60 MICH. L. REV. 841, 845 (1962) ("In life insurance, there seems little doubt that, absent contractual stipulation, subrogation would be denied uniformly. Dicta are plentiful, but no cases actually decide the matter.").

[50] *See, e.g.*, Michigan Hospital Service v. Sharpe, 63 N.W.2d 638, 644 (Reid, J. dissenting), (quoting 29 Am. Jur. 1003-04) (Mich. 1955) ("There seems to be little doubt that a life insurance company cannot recover of one who

such subrogation reimbursement by contract – as health and disability insurers have long provided – this practice never developed either. The explanation probably is that market forces prevented contractual subrogation in life insurance from arising. Any life insurer seeking to vindicate its subrogation rights would likely have had to do so against a widow or orphan who had obtained a tort recovery for the death of an insured husband or father. These circumstances would not have been propitious ones for companies in an industry competing largely on the basis of reputation and reliability rather than product differentiation. So subrogation rights stayed out of life insurance policies.

This state of affairs was almost certainly reinforced by the limitations on recovery for wrongful death that obtained until relatively recently. Unlike recovery for non-fatal injury or illness, recovery for wrongful death is a creature of statute. And originally the statutes creating a cause of action for wrongful death contained two important limitations: a right to recover for economic loss only, and comparatively modest monetary ceilings on recovery even for economic loss.[51]

In view of these limitations on recovery of the amount of loss resulting from tortiously-caused death, the absence of life insurers' subrogation reimbursement rights may well have been seen as a sensible counterweight to the risk of undercompensation. Life insurance helped to top-up partial recoveries in tort for wrongful death and thereby to promote full compensation overall. Exempting life insurance from the treatment accorded all other collateral sources, that is, was a

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has caused the death of an insured the amount which it has thereby been compelled to pay.")

[51]*See* DAN B. DOBBS, THE LAW OF TORTS § 296, at 807-11(2000).

way to promote loss distribution.

In the second half of the 20th-century, however, the last vestiges of the two limitations on the damages that may be recovered for wrongful death largely disappeared. Both the prohibition on awarding damages for intangible loss resulting from wrongful death, and monetary ceilings on total recoveries, were eliminated. The rationale for exempting life insurance payments from the treatment accorded the other forms of insurance that also are available to tort claimants and their families has therefore also disappeared.

Any altered treatment of life insurance under the collateral source rule, however, would have implications for more fundamental questions about the relationship between tort recoveries and need. Life insurance is merely one form of savings. Why should those who have chosen this form of savings have it deducted from their tort recoveries, whether directly or indirectly, while those who have chosen a different form of savings do not incur a deduction?[52] That is, would it be inconsistent to subect life insurance benefits to the same treatment as other collateral source payments but to ignore other sources of wealth available to the victim's survivors?

The argument that there would be no inconsistency is that life insurance is a very particular form of savings. Unlike any other form, life insurance (and the devices allied with it, such as lifetime annuities) is stochastic. That is, setting aside any investment feature that is added to it, life insurance is never available until death is certain, or virtually so.[53] Life insurance is

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[52]This is essentially the problem that has created the most controversy over the September 11 Victims' Compensation Fund, which, unlike tort, does reduce the benefits recoverable from the Fund by life insurance payments. *See* Kenneth S. Abraham and Kyle Logue, *The Genie and the Bottle: Collateral Sources under the 9/11 Victims Compensation Fund*, 54 DEPAUL L. REV. __ (2004).

[53]Accelerated, or "viatical" settlements in connection with life insurance are the exception to the notion that

designed to protect against future loss of income, whereas other forms of savings are or could immediately be converted into present income. Thus, life insurance is a current asset, but not current income. Indeed, conceived as savings, perhaps the asset value of life insurance is only the premium that is paid for it.

The distinction between assets and income does not resolve the issue, however, but merely shifts the focus of the question. Why not offset against recoveries in tort for wrongful death both all current income and all assets that can be converted into income, rather than offsetting only insurance benefits? The answer depends on how this would fit with the goal of promoting loss distribution. One view is that loss distribution is desirable in general, because of the diminishing marginal utility of money. The very fact that people tend to be risk averse and therefore purchase various forms of insurance is some confirmation of this view. It follows from this view that imposing a comparatively small loss on a large number of people will reduce overall utility less than imposing a large loss on one person, regardless of these individuals' wealth. To the extent that this is true, then it may make sense to ignore assets and savings in determining how tort law should treat collateral sources.

An alternative view, however, is that we value loss distribution not only because of the diminishing marginal utility of money generally. From a moral standpoint, we may also value loss distribution because it has the potential to satisfy the needs of those who have no other means of obtaining compensation for their losses. In this sense loss distribution is a good because of its

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life insurance policies pay only upon the death of the party whose life is insured. These settlements are paid when death is virtually certain and imminent. *See* KENNETH S. ABRAHAM, INSURANCE LAW & REGULATION: CASE AND MATERIALS 293-94 (2000).

potential for improving the condition of those who need to have their losses mitigated. To the extent that this is the case, the savings or wealth of a claimant should be treated in the same way as her first-party and social insurance "wealth," since the wealthier the claimant, the less need there is to mitigate her losses.

Of course, putting this line of reasoning into practice would bring us a long way from the traditional collateral source rule, and would ask tort law to take more factors into account in calculating damage recoveries than would be realistic. We are not about to means-test tort recoveries, precisely because loss distribution is not tort law's main goal. Concerns about deterrence and corrective justice so dominate tort that, even if we thought it otherwise desirable to do so, there would be no way to means-test recoveries across the board and still maintain the levels of liability necessary to achieve deterrence and corrective justice. Potential defendants' levels of care would significantly decline, because of the decreased magnitude of liability they would face, and everyone would be significantly worse off because of the substantial increase in tortiously-caused loss that would result. Any loss-distributional aims that tort law pursues must therefore be interstitial, deferring where necessary to tort law's more dominant purposes.

B. Transforming the Treatment of Collateral Sources

With the interstitial loss distribution effects of different approaches to collateral source payments and the issue of how to treat life insurance both on the table, it is time to take a step back and look at the big picture. We have seen that the central challenge for tort law's treatment of collateral sources is how to preserve deterrence while at the same time taking advantage of the much greater of efficiency of first-party and social insurance as methods of compensation. Offsets sacrifice deterrence in order to accord these forms of insurance loss-distributional priority. Nonoffsets preserve deterrence, but at the cost of some combination of possible overcompensation, significant administrative expense, and making tort – an inefficient loss distributor -- the primary source of compensation. We are thus faced with a choice between unsatisfactory alternatives.

Two principles can help lead away from this dilemma. The first principle, already noted, is that first-party and social insurance are superior to tort as methods of affording compensation, because the compensable event under these systems is simple and easily applied. The result is that a much higher proportion of the money invested in loss distribution finds its way into the pockets of victims under first-party and social insurance than in tort. The second principle is that, from a loss distributional standpoint, out-of-pocket expenses should have a higher compensation priority than intangible loss. It may be arguable that awarding pain and suffering damages serves corrective justice; and in my view awards of at least some damages for pain and suffering are necessary to promote optimal deterrence. But although pain and suffering is a real social cost, the loss that pain and suffering damages reflect cannot be "distributed" by awarding victims monetary compensation. The victims of pain and suffering do not need their losses distributed; they need their pain and suffering relieved. Paying damages for pain and suffering does not relieve pain and suffering. It is instead an economic substitute for relief, as well as a means of attempting to ensure that the plaintiff's counsel fees can be paid without depriving her of compensation for out-of-pocket loss.[54]

[54]It may be that ceilings on pain and suffering damages, otherwise deeply objectionable on equitable grounds, are also a crude reflection of the idea that only secondary priority should be accorded to pain and suffering awards. Ceilings, however, extract the entire burden of reform from two groups. The first group is composed of those who are awarded damages for pain and suffering that exceed the pain and suffering they have actually experienced. This group has no legitimate complaint about ceilings. The second group, however, is composed of those whose pain and suffering would otherwise warrant an award in excess of the ceiling. Because life expectancy is a prime

Combining these two principles with the desirability of preserving deterrence suggests an alternative approach. We should permit potential tort victims to invest their available insurance dollars more heavily in first-party insurance protecting them against the risk of suffering out-of-pocket loss, rather than on tort "insurance." But we should continue to threaten defendants with liability for the full social cost of harm they cause, including intangible loss.

A number of scholars have proposed full-subrogation approaches that would allow this ideal to be approached. In one way or another they propose authorizing plaintiffs to sell their tort causes of action in return for additional protection against out-of-pocket loss.[55] What these approaches amount to, using the kind of terminology I employed in Part II, is "nonoffsets with total collateral recovery." The plaintiff would continue to have formal tort rights, but her first-party insurance contract would provide that her total tort recovery – not merely the benefits already paid or payable by the insurer – would be returned to her insurer as subrogation reimbursement. The plaintiff would then be a plaintiff in name only, since the real party in interest would be her first-party insurer.

This general approach would preserve the deterrence that is a central feature of the nonoffset approaches, but would enable potential tort claimants to transform their right to recover pain and suffering damages into less expensive, or more broadly protective, first-party insurance.

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ingredient in the determination of a pain and suffering award where pain and suffering is permanent, this group will be disproportionately composed of young, seriously injured victims – especially children. Therefore, it is seriously injured children who are likely to be most disadvantaged by the enactment of ceilings.

[55] *See, e.g.*, CHARLES FRIED & DAVID ROSENBERG, MAKING TORT LAW 91-92 (2003) (tort rights to be transferred to first-party insurers); Robert Cooter & Steven D. Sugarman, *A Regulated Market in Unmatured Tort Claims: Tort Reform by Contract*, in WALTER OLSON (ed.), NEW DIRECTIONS IN LIABILITY LAW 174 (1988) (tort rights to be transferred to employers); Jeffrey O'Connell & Janet Beck, *Overcoming Legal Barriers to the Transfer of Third-Party Tort Claims as a Means of Financing First-Party No-Fault Insurance*, 58 Wash. Univ. L. Quart. 55 (1979) (tort rights to be transferred to first-party insurers).

Of course, the details of this approach need to be worked out in more detail. It ought to be provided as an option for policyholders to accept or reject, and even then only after significant efforts have been made to ensure that the policyholder has given informed consent to the arrangement. That way the state would not decide the proper mix of tort rights and insurance for all individuals; that decision would be made individually rather than collectively, as is now done.

Since the vast majority of private first-party insurance is employment-related group health insurance, a method of returning premiums saved or providing additional coverage to the individual policyholders electing the option would have to be developed as well. A method of designating the insurer that would hold the the newly-enhanced right of subrogation reimbursement would also be required. It is easy enough to picture a bifurcation, however, under which health insurers (for example) received the right to payment of all damages for out-of-pocket expenses and conscious pain and suffering, whereas the right to recover damages for wrongful death was transferred to life insurers, with corresponding reductions in premiums or increases in the amounts of coverage provided by these sources.

The victims of torts might also have to be provided with an incentive to participate actively in the insurer's conduct of tort suits, since victims would effectively become mere witnesses without any economic stake in the outcome. Some sharing of pain and suffering damages by the victim and the insurer above a specified level might prove to be an optimal method of obtaining this participation. Since certain insurance companies might come to specialize in this form of recovery, and as a secondary market involving tort lawyers representing these insurers probably would develop, competition among insurers would likely generate a variety of options. Finally, the subrogation reimbursement rights of other collateral sources would have to be preserved, so that (for example) disability insurers were reimbursed by health insurers out of the tort recoveries that health insurers obtained.

But these are operational features, some of which the proponents of this approach have already addressed. Although the devil is sometimes in the details, the principle of the matter must be the first item on the agenda. No doubt the most seriously injured victims who had previously opted into the new approach would experience *ex post* regret at the choice they had made. This would be no different from the other tort-waiver choices that we permit individuals to make, however, and indeed no different than some choices we make for them – including the universal enactment of workers' compensation as a substitute for tort and the enactment of mandatory auto no-fault in a number of states.[56] In event, at present we make the opposite decision mandatory, by holding in most instances that the waiver of tort rights prior to injury is invalid.[57]

This approach might well help to fill part of the gap in the fabric of protection against out-of-pocket loss that still remains and so troubles both the tort and social welfare systems. As I noted earlier, there are still substantial gaps in the fabric of protection provided by first-party insurance. Fifteen percent or more of the population has no health insurance; nearly one-fifth of the cost of out-patient medical care is uninsured; few income-earners have private or public disability insurance that provides more than slightly-above-subsistence level wage-loss protection, many having only social security protection against long-term, total disability; and

[56] Admittedly, however, these systems usually eliminate the tort rights of the least seriously injured, not those with the greatest prospects of recovering pain and suffering damages. For what may be the earliest proposal to make the choice between tort and auto no-fault optional, *see* Guido Calabresi, *The New York Plan: A Free Choice Modification*, 71 COLUM. L. REV. 267 (1971)

[57] *See, e.g.*, Tunkl v. Regents of the University of California, 383 P.2d 441 (Ca. 1963).

most families have insufficient life insurance to protect them against the income loss they would suffer upon the death of the principal wage-earner in the family.[58]

Tort has not filled these gaps, nor has political action on the health and disability insurance fronts for several decades now. Perhaps by creating a market for potential tort claims, revision of the collateral source rule can do what we have thus far failed to do – contribute to the provision of sufficient health-care and income-loss protection for everyone in the United States. If the uninsured cannot now afford to pay for health and disability insurance with currently available funds, some of them may be willing to pay part of the necessary premium for such coverage by transferring their right to recover for personal injury in tort to these insurers, in return for insurance coverage that they can afford. We would then have achieved greater loss distribution, not by expanding the scope of tort liability, but by modifying the relationship between tort recoveries and collateral sources and creating a means by which tort rights can be transformed into superior forms of insurance. I do not want to argue that this change alone would be sufficient to provide health or disability insurance to all the uninsured. But it might make a start.[59]

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[58] B. Douglas Bernheim, Lorenzo Forni, Jagadeesh Gokhale, & Laurence J. Kotlikoff, The Adequacy of Life Insurance: Evidence from the Health and Retirement Survey (NBER Working Paper #7372) (October 1999). In the authors' sample, almost one third of wives and more than 10 percent of husbands would have suffered living standard reductions of 20 percent or more had their spouses died in 1992. The authors also found that underinsurance tends to be more common among low-income households, couples with asymmetric earnings, younger households, couples with dependent children, and non-whites. Among some groups, the frequency of underinsurance exceeds two-thirds. This paper can be found at http://www.nber.org/papers/w7372.

[59] A rough but conservative calculation would run as follows. Of the $80 billion in tort payments made each year, slightly more than half, or about $40 billion, is paid for noneconomic loss. *See* U.S Tort Costs, note _ *supra*, at 17. Approximately 15 percent of the population is uninsured for health care. Therefore, about 15 percent of $40 billion, or $6 billion, is available for recovery by first-party insurers on behalf of previously uninsured or underinsured individuals. Total health insurance benefits paid each year are $846 billion. *See* text at note __, *supra*. Providing corresponding benefits to the 15 percent of the population that is uninsured would cost an additional 15 percent of this sum, or about $125 billion. Thus, transferring full rights of tort recovery by the uninsured to first-party

At the same time, the effects on the market for legal services might be salutary. At present, the contingent-fee system is necessary at least in part because plaintiffs have no other way to manage the huge payment that would otherwise be due their attorneys. Once the purchasers of the services of plaintiffs' personal injury attorneys are more often be first-party insurers, they may be able to take advantage of the greater clout that the reform would put in their hands.[60] A more competitive and perhaps very different market for the services of personal injury attorneys might be the result.

CONCLUSION

The world of insurance has changed enormously since the collateral source rule was first developed. At that time the payment of insurance benefits to tort plaintiffs by collateral sources was a rarity. Now this is routine. Similarly, the reasons for the exemption of life insurance from standard subrogation rules and practices no longer apply. But gaps in the fabric of first-party and social insurance protection still exist. By looking at tort and this fabric of protection as one system, we can see that neither the collateral source rule as we know it nor legislative reversals of the rule optimize the deterrence and insurance functions of this system. To achieve this goal, individuals should be given the right to transfer full subrogation rights to first-party insurers, in return for lower premiums or expanded insurance.

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insurers would pay for about 5 percent of the cost of providing health insurance to these individuals.

[60] For discussion of the flaws in this market, s*ee* LESTER BRICKMAN, MICHAEL J. HOROWITZ, AND JEFFREY O'CONNELL, RETHINKING CONTIGENCY FEES: A PROPOSAL TO ALIGN THE CONTINGENCY FEE SYSTEM WITH ITS POLICY ROOTS AND ETHICAL MANDATES (Manhattan Institute 1994).